INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Summary of argument	7
Argument:	
I. The court below correctly decided that petitioner in equity and good conscience is not entitled to recover	8
II. Section 44 (d) of the Revenue Act of 1928 is constitutional	18
Conclusion	36
Appendix A	37
Appendix B	48

CITATIONS

Cases:	
Blum's Inc. v. *Commissioner*, 7 B. T. A. 737	19
Brewster v. *Gage*, 280 U. S. 327	20
Bull v. *United States*, 295 U. S. 247	10, 13, 14, 15, 16, 30
Burnet v. *S. & L. Bldg. Corp.*, 288 U. S. 406	19, 20
Crane v. *Helvering*, 76 F. (2d) 99	22, 35
Crocker v. *Malley*, 249 U. S. 223	12
H. B. Graves Co. v. *Commissioner*, 1 B. T. A. 859	19
Helvering v. *Twin Bell Oil Syndicate*, 293 U. S. 312	24
Hoover-Bond Co. v. *Commissioner*, 1 B. T. A. 929	19
Lawlor v. *Commissioner*, 78 F. (2d) 567	22
Lewis v. *Reynolds*, 284 U. S. 281	10, 11, 17
McLaughlin v. *Alliance Ins. Co.*, 286 U. S. 244	19
Moore v. *United States*, 10 F. Supp. 143	22
Myers v. *Hurley Motor Co.*, 273 U. S. 18	12
Nuckolls v. *United States*, 76 F. (2d) 357	22, 35
Provident Trust Co. of Philadelphia v. *Commissioner*, 76 F. (2d) 810	22
W. A. Shaeffer Pen Co. v. *Lucas*, 41 F. (2d) 117	24
650 West End Avenue Co. v. *Commissioner*, 2 B. T. A. 958	19
Stone v. *White*, 301 U. S. 532	7, 10, 11, 12, 14, 15, 16, 17
B. B. Todd, Inc. v. *Commissioner*, 1 B. T. A. 762	19
United States v. *Freeman*, 3 How. 556	24

Cases—Continued.	Page
United States v. *Jackson*, 104 U. S. 41	10
United States v. *Jefferson Electric Co.*, 291 U. S. 386	12
United States v. *Phellis*, 257 U. S. 156	27
Williams v. *Commissioner*, 79 F. (2d) 518	22
Statutes:	
Revenue Act of 1924, Sec. 202 (c), c. 234, 43 Stat. 253	27, 30
Revenue Act of 1926, c. 27, 44 Stat. 9, Secs. 202, 212 (d), 1208	37
Revenue Act of 1928, c. 852, 45 Stat. 791:	
Sec. 44 (d)	38
Sec. 101	28
Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 44	39
Miscellaneous:	
H. Rep. No. 2, 70th Cong., 1st Sess., pp. 14, 16	23, 46
H. Rep. No. 1492, 72d Cong., 1st Sess., p. 13	25
S. Rep. No. 52, 69th Cong., 1st Sess., p. 19	44
S. Rep. No. 665, 72d Cong., 1st Sess., p. 21	25, 47
Treasury Regulations 45, Art. 42	40
Treasury Regulations 74, Art. 355	42

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 6

D. W. McEACHERN, ADMINISTRATOR OF THE ESTATE OF S. C. McEACHERN, DECEASED, PETITIONER

v.

J. T. ROSE, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF GEORGIA

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 57–62) is reported in 86 F. (2d) 231. There was no opinion of the District Court, the case being tried before a jury and both parties moving for a directed verdict.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 9, 1936 (R. 62). On February 1, 1937, Mr. Justice Cardozo entered an

order of this Court extending the time for filing a petition for certiorari in the case at bar to and including February 24, 1937 (R. 67). The petition for a writ of certiorari was filed February 23, 1937, and was granted April 5, 1937 (R. 67). The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. In a suit to recover taxes paid on income erroneously reported in returns for 1929, 1930, and 1931 was evidence that the income should have been reported in the return for 1928, and a much larger tax paid thereon, properly admissible as a defense?

2. Is Section 44 (d) of the Revenue Act of 1928 constitutional?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra,* pp. 37–47.

STATEMENT

On September 3, 1924, S. C. McEachern, the decedent, sold 500 shares of the capital stock of the Industrial Life & Health Insurance Company to J. N. McEachern for the sum of $300,000, $30,000 of which was to be paid on that day in cash. The balance, under the contract of purchase, was payable in quarterly installments of $7,500 each, the first being due March 1, 1925, and "a like sum of

$7,500.00 on the first day of each and every third month thereafter until the full balance of $270,000.00 is fully paid" (R. 3, 14). The cost basis of this stock in the hands of decedent was $10 per share, which was the price paid by him for said stock (R. 47).

Decedent chose to treat this sale as an installment sale for income tax purposes under the applicable regulations, and during the years prior to his death he reported the proportionate profits on the respective installments collected in each year, based on the original cost of the stock to decedent, as income (R. 16, 19, 22). Decedent died intestate on December 12, 1928. On February 4, 1929, letters testamentary were granted upon the estate of the decedent to D. W. McEachern, the present petitioner, and on the same day the said D. W. McEachern qualified as administrator of the estate (R. 1).

In filing income tax returns for the estate for the years 1929, 1930, and 1931, the administrator reported as income the proportionate profits on the respective installments collected in each of said years, based on the original cost of the stock to decedent, and paid the taxes for said periods upon that basis (R. 40–45). These returns did not indicate that the items referred to represented collections on installment obligations, but, on the contrary, indicated that the items represented separate sales of stock occurring during each taxable year (R. 26–39).

On December 9, 1932, petitioner filed his claims for refund of the taxes paid on those installments for the years 1929, 1930, and 1931, aggregating $3,858.34, urging that the installments were not income except to the extent that they exceeded the fair market value at the death of decedent of the right to receive the remaining installments (R. 4, 8, 13). These claims for refund were rejected by the Commissioner of Internal Revenue on May 17, 1933, and the petitioner was duly advised of said action on that date (R. 4, 8, 13). This suit was thereupon commenced by the petitioner for the recovery of the amounts so paid.

In his answer respondent did not contest the fact that the taxes sued for were erroneously reported and paid in the years 1929, 1930, and 1931. However, respondent set up an affirmative defense to each count, in which it was alleged that the income upon which the taxes sued for were paid should have been reported by petitioner and a tax paid thereon in the return filed on behalf of the decedent for the year of his death, namely, 1928. The affirmative defenses further alleged that in view of this fact it would be unconscionable to allow petitioner a recovery in this case, and that petitioner was estopped from such a recovery (R. 15–24).

At the trial respondent offered in evidence a stipulation showing the following facts: On March 12, 1929, petitioner, as administrator of the estate of S. C. McEachern, deceased, filed with the Col-

lector of Internal Revenue an income tax return on behalf of said S. C. McEachern for the period from January 1, 1928, to December 12, 1928, the date of the death of said S. C. McEachern. The income tax due according to said return was $1,441.70, which was duly paid. The return shows the sale of fifty shares of Industrial Life & Health Insurance Company stock, with a net profit of $29,500. The return did not show that the profit referred to was derived from a collection on an installment obligation. In the return petitioner did not include any gain or profit received by the said S. C. McEachern which was taxable at the time of the transmission by death from the said S. C. McEachern to his estate of the installment obligations remaining unpaid under the contract of September 3, 1924. Under Section 44 (d) of the Revenue Act of 1928 a gain based on the remaining installment obligations should have been reported in the return for the period of January 1, 1928, to December 12, 1928, and an additional tax in the sum of $11,625 paid thereon (R. 46–48).

On the date of filing by petitioner of the claims for refund of the taxes paid for the years 1929, 1930, and 1931, upon which this action is based, the time for making an additional assessment of taxes for the 1928 period had expired (R. 19–30).

The petitioner objected to the introduction of the stipulation offered by respondent, and the objection was sustained on the ground that the facts

covered by this stipulation were irrelevant, in that they undertook to support a defense of estoppel, and even though the stipulation were admitted, estoppel would not be established (R. 49). To this ruling respondent duly excepted (R. 49).

Petitioner offered in evidence certain paragraphs of another stipulation showing that the Federal estate tax return filed for the estate of S. C. McEachern by petitioner listed among the assets of the estate "an unpaid balance of deferred payments on 250 shares of stock of the Industrial Life & Health Insurance Company under contract between S. C. McEachern and J. N. McEachern, as trustee, dated September 3, 1924 * * * $125,000" (R. 39). Respondent objected to the admission of this evidence, but the objection was overruled (R. 45–46).

On the date of the death of S. C. McEachern, the unpaid installment obligations were of a face value of $150,000, and had a fair market value of $125,000 (R. 40). This latter figure was determined by deducting from the face amount of the then future installment payments a discount of approximately 6.348 percent per annum from the date of the death of S. C. McEachern to the average due date of the installments.

After the close of the evidence, both sides moved for a directed verdict. The District Court directed a verdict for petitioner. On appeal the Circuit Court of Appeals reversed, on the ground that the stipulation offered by respondent was admissible

and established a good defense, since it showed that in equity and good conscience petitioner was not entitled to recover.

SUMMARY OF ARGUMENT

The income on which petitioner erroneously paid taxes in 1929, 1930, and 1931, should have been reported and taxed in 1928 under Section 44 (d) of the Revenue Act of 1928. Since petitioner failed to report this income and pay a tax thereon in 1928, as required by law, and since the taxes so payable, but now uncollectible by reason of the statute of limitations, are greater than the taxes actually paid on the income, it would be inequitable to allow petitioner a recovery of the taxes paid. This is an action for money had and received, based on equitable principles, in which petitioner must show that respondent wrongfully withholds money equitably due petitioner. Where, as here, the money received by respondent, though received under a technical mistake in procedure under the revenue laws, was no greater than was justly due from petitioner as taxes on the income, no right of recovery in this form of action exists. *Stone* v. *White*, 301 U. S. 532. No violation of the statute of limitations results from the application of these equitable principles to this case.

In requiring the taxation of the income in 1928, Section 44 (d) is constitutional. It simply provides for the termination of the privileges granted by the installment basis of reporting income, when, because of the disposal by the taxpayer of the in-

stallment obligation, the continuance of those privileges would result in an avoidance of tax. Section 44 (d) does not tax that which is not income under the Sixteenth Amendment; it taxes the remaining portion of the profit realized by the taxpayer on the sale in which the installment obligation was received.

ARGUMENT

I

THE COURT BELOW CORRECTLY DECIDED THAT PETITIONER IN EQUITY AND GOOD CONSCIENCE IS NOT ENTITLED TO RECOVER

By Section 44 (d) of the Revenue Act of 1928 petitioner was required to report as income accruing to decedent in 1928, the year of death, the remaining portion of decedent's profit from the sale of the Industrial Life & Health Insurance Company stock in 1924. This petitioner failed to do. The return filed for 1928 made no mention of the installment obligation. While the amount of the payments on the obligation received during 1928 was included, this amount was stated as a separate sale in 1928 of fifty shares of the stock (R. 47). The additional tax legally payable by petitioner for 1928 on this unreported income is stipulated to be $11,625 (R. 47), no part of which petitioner has paid. Collection is now barred by the statute of limitations, and was barred at the time petitioner filed the claims for refund upon which this suit was brought.

Instead of reporting this income in 1928, petitioner, by mistake, reported it partially in each of the three returns filed on behalf of the estate for the years 1929, 1930, and 1931, and paid taxes thereon. The taxes so paid mistakenly, however, amounted to only $3,858.34, so that by reason of petitioner's mistake the Government has already lost $7,766.66 in revenue that was justly due. Petitioner now asks this Court for a return of the $3,858.34, which would free the income from all taxes whatsoever and would cause the Government to lose the entire $11,625 that should have been paid.

Under these circumstances we submit that the Circuit Court of Appeals correctly decided that the petitioner "ought not in good conscience" to recover, and that its judgment accordingly should be affirmed.[1] Respondent has not been unjustly enriched at the expense of petitioner. On the contrary, petitioner, through its own error, has already avoided payment of the greater part of the taxes justly due. In view of the equitable character of the petitioner's action, he should not be allowed to undo the payments actually made and escape taxation upon the transaction altogether.

---

[1] The respondent in his answer to each count, after setting forth the facts and pleading that "it would be unconscionable for the plaintiff to be allowed any recovery from the defendant", asserted also that "plaintiff is estopped to assert and claim that any portion of the taxes in controversy in this action were not taxable to said estate * * *"

The decisions of this Court in *Stone* v. *White*, 301 U. S. 532; *Bull* v. *United States*, 295 U. S. 247; and *Lewis* v. *Reynolds*, 284 U. S. 281, among others, clearly support the conclusion of the Circuit Court of Appeals. This case, although arising on different facts, presents exactly the same equitable situation involved in *Stone* v. *White, supra*. There trustees had paid taxes which legally should have been paid by the beneficiary of the trust. Recovery of the taxes by the trustees was denied on the ground that the proceeds of recovery would inure to and unjustly enrich the beneficiary, and hence

---

(R. 17, 18, 19, 20, 23, 24). The Circuit Court of Appeals, in holding that petitioner was not entitled to recover, said (R. 61):

"This is so not because of the existence of a technical estoppel or a waiver, but because his action was equitable in its nature and grounds, and he may not succeed in it unless he can show that the defendant has money which, *ex aequo et bono*, the defendant ought to refund."

The respondent does not now urge, as a distinct ground for affirming the judgment below, the existence in this case of a "technical estoppel." This is not, however, for the reasons advanced against such a contention in the brief for the petitioner.

The Commissioner did not here have "timely knowledge of all the material facts", as in the cases there relied upon. This Court will take judicial notice of the method of organization of the Bureau of Internal Revenue. *United States* v. *Jackson*, 104 U. S. 41. To charge the Government in the handling of income tax returns with the knowledge of the contents of estate tax returns would be pure fiction, and would require, if the Government wished to protect itself from misrepresentations and non-disclosures of fact subsequently revealed after the statute of limitations had run, the investigation of many thousands of returns now accepted

that the trustees could not show that they were equitably entitled to the money.

The action here is a suit against the collector for a refund of income taxes, as was the action in *Stone* v. *White*. All that was said there concerning the equitable nature of the proceeding as a successor of the common count in *indebitatus assumpsit* for money had and received is fully applicable here. It was there settled that no recovery could be had in this type of action without a showing that the defendant holds money to which the plaintiff is equitably entitled. To the same effect see *Lewis* v.

---

without investigation for reasons of economy and public policy.

Nor is there room in this case for the contention that the Commissioner should have discovered the facts by his own investigation of the returns filed. The returns were doubly in error in selecting the wrong basis for determining gain upon the payments received, and in stating that the payments were received pursuant to a separate sale in the taxable year. It is sheer speculation to assert that inquiry into the first error would have disclosed the second. See Brief for the Petitioner, 21, 22.

The Commissioner's failure to collect the tax for 1928 under Section 44 (d) resulted plainly enough from the petitioner's failure to disclose the fact making for taxability—namely, the existence of an installment obligation. Doubt as to the existence of a technical estoppel arises only from the fact that petitioner's present case does not necessarily involve a reversal of his previous position that the payments were received pursuant to a separate sale. His recovery, accordingly, would not in strictness be defeated by an "estoppel" against denial of that earlier misrepresentation. The misrepresentation, on the other hand, together with the element of resulting unjust enrichment, is plainly ground for defense to an action equitable in character.

Reynolds, 284 U. S. 281, 283; *United States* v. *Jefferson Electric Co.,* 291 U. S. 386, 402; *Myers* v. *Hurley Motor Co.,* 273 U. S. 18, 24; *Crocker* v. *Malley,* 249 U. S. 223. As was said by this Court in *United States* v. *Jefferson Electric Co., supra* (pp. 402–403):

> This is often called an equitable action and is less restricted and fettered by technical rules and formalities than any other form of action. It aims at the abstract justice of the case, and looks solely to the inquiry, whether the defendant holds money, which *ex aequo et bono* belongs to the plaintiff.

The abstract justice of this case is identical with that of *Stone* v. *White, supra.* Here, as there, petitioner paid taxes on certain income in an erroneous manner under the technicalities of the tax laws, but the taxes paid were no more than were rightfully due on the income, and petitioner was in no way prejudiced by the error. In *Stone* v. *White* the tax was paid by the trustees when it should have been paid by the beneficiary, but no one was prejudiced since the tax in reality came from the beneficiary's funds. At bar the tax was paid on returns on behalf of the estate when it should have been paid on a return on behalf of the decedent, but no one is prejudiced since in either event payment comes from the same source, namely, the estate. Indeed, in this case, unlike *Stone* v. *White,* the tax-paying entity is identical.

The equity of respondent's position is not destroyed by the fact that the payments were made in different years from that in which they were legally due. It is a tax on the same income that is involved, and the erroneous dates of payment cannot affect the fact that the Government is entitled to retain a tax on that income. This is not a case where a separate barred tax liability on different income for a different year is sought to be applied to defeat refund of an overpayment of taxes on other income received during a later year. The taxes sought to be recovered here were paid on the income arising from the sale of stock by decedent in 1924, and the facts offered in evidence by respondent at the trial show that the taxes on *that income* have not been overpaid.

In this respect, the case resembles *Bull* v. *United States, supra,* in which the same interest had been treated erroneously, as a right to profits constituting capital passing at the decedent's death and subject to the estate tax, and subsequently had been correctly taxed as income received by the estate. This Court held the taxpayer entitled to recover so much of the income tax payment as duplicated the mistaken estate tax payment. "If the claim for income tax deficiency had been the subject of a suit", the Court said (p. 262), "any counter demand for recoupment of the overpayment of estate tax could have been asserted by way of defense and credit obtained * * *." Such a suit—save only

for the reversal of the parties—would have been almost the precise counterpart of this proceeding.

No violation of the statute of limitations results from the application of these equitable principles to deny a recovery by the petitioner. This is not a case, it should be emphasized, in which a barred tax liability is sought to be applied against a later mistaken payment on distinct income. As the Court said in *Stone* v. *White, supra* (301 U. S. at 538):

> The statutory bar to the right of action for the collection of the tax does not prevent reliance upon a defense which is not a set-off or a counterclaim, but is an equitable reason, growing out of the circumstances of the erroneous payment, why petitioners ought not to recover.

The payments for which petitioner is now suing were made before the falling of the bar of limitations applicable to the years for which the payments were made. The showing by which petitioner establishes that the income reported was not taxable in those years discloses that the income was taxable in another year for which it was not reported. In equity and good conscience, petitioner ought not to be able thus to undo a timely payment by a belated disclosure rendering it untimely.

The right of the Government under these circumstances to retain the money actually received may be taken as conclusively established by the decisions in *Stone* v. *White* and *Bull* v. *United States*,

supra, unless a single ground of distinction suggested by the petitioner affords a basis for differentiation. In *Stone* v. *White,* as the petitioner points out, the erroneous payment was made before collection on the correct basis had been barred. Conversely, in *Bull* v. *United States,* it appeared that the taxpayer's proper claim for refund could still have been asserted affirmatively at the time when the Government first proceeded against him on a correct theory of liability—although not at the time when the payment was made of which refund was sought. In the instant case all but $230.07 of the amount sued for was paid after the limitations period expired for the year 1928. We do not think that this circumstance is material; nor did the Court so treat it in the *Stone* and *Bull* cases. The Court in *Stone* v. *White,* citing a similar statement in the *Bull* case, said (p. 539):

> The government, by retaining the tax paid by the trustees, is not reviving a stale claim. Its defense, which inheres in the cause of action, is comparable to an equitable recoupment or diminution of petitioners' right to recover. "Such a defense is never barred by the statute of limitations so long as the main action is timely." *Bull* v. *United States,* 295 U. S. 247, 262 * * *.

In the *Stone* case, as here, the grounds upon which the Government's defense rested were not disclosed, and the defense was not asserted, until after the bar of the statute had fallen upon a claim

of affirmative liability.[2] To make the decision in that case turn upon the circumstance that the Government, had it had full information, might have attributed the payment to the correct liability, or might still have proceeded against the taxpayer upon that liability,[3] would be to emphasize an illusory opportunity, irrelevant to the broad equitable grounds upon which the Court's reasoning proceeded. No more in this case than in that is there undue danger to general principles of repose, for in no event can a defense be asserted which does not arise out of the same transaction with reference to which a timely suit is brought.

Petitioner's brief argues that the defense of "recoupment" is not open under the pleadings. The defense relied upon by the respondent, by whatever name called, was urged in both courts below and

---

[2] In the *Bull* case, the taxpayer evidently learned of the Government's income tax claim before it was too late to file claim for refund of the estate tax payment. But this fact, if significant at all, weakens rather than otherwise the reasons for permitting recoupment.

[3] The opinion of the Court in *Stone* v. *White* refers to the circumstance of the time of the erroneous payment in the statement of facts (p. 533), but does not recur to it expressly in discussion of the problem. That circumstance, it should be pointed out, had a significance in the *Stone* case for which there is no parallel here. The erroneous payment had there been made in response to a deficiency assessed by the Commissioner. The time of the assessment was therefore evidence of the good faith of the Commissioner, serving to establish that "the government * * * [was] not reviving a stale claim" (p. 539).

was expressly made the ground of decision by the Circuit Court of Appeals (R. 61, 62). Petitioner did not contend in seeking a writ of certiorari that the court below had erred in deciding the case upon a ground not open on the record; and he may not so contend now. The respondent is accordingly free, under any view of the record, to take the position that the case was correctly decided upon the ground on which it was decided.

The defense in question, although in the nature of an equitable recoupment, is not strict recoupment but rests upon the necessity that the plaintiff in an action of this kind prove that he is justly and equitably entitled to the money he seeks. Respondent in this case was entitled to show any state of facts which would deny the equity of petitioner's claim, even if the answer went no further than a general plea of non-assumpsit, without resort to modern statutory authority for pleading equitable defenses in law actions. *Stone* v. *White, supra,* at 535. In *Lewis* v. *Reynolds, supra,* recovery was denied by reason of similar equitable principles, and the record in that case (No. 115, October Term, 1931) shows that the facts constituting the defense were not set up in the answer.

The defense here relied upon, however, was directly and unequivocally pleaded. The answer, in response to each count of the petition, sets up in detail the facts concerning the failure to report the income and pay a tax thereon in 1928, and con-

cludes that "it would be unconscionable for the plaintiff to be allowed any recovery from the defendant" (R. 16–20, 22–24). Plainly, on this state of the pleadings, the District Court erred in refusing to receive the evidence offered by the respondent concerning the year 1928. We submit that the court below correctly decided that under the facts in this case petitioner had not shown that respondent held money to which petitioner in equity and good conscience was entitled, and therefore had not made out a cause of action.

II

SECTION 44 (d) OF THE REVENUE ACT OF 1928 IS CONSTITUTIONAL

Respondent's defense to the claim of petitioner for refunds in this case is based on the failure of petitioner to report in the return for 1928, under the provisions of Section 44 (d) of the Revenue Act of 1928, the income which in part was thereafter erroneously reported for the years 1929, 1930, and 1931, and to pay a tax thereon for the year 1928 in an amount greater than that which has been paid in the later years. The ultimate answer which petitioner seeks to make to this defense is that Section 44 (d) of the Revenue Act of 1928 is unconstitutional.

Section 44 (d) is a part of what is known as the installment basis of accounting, whereby profits derived from installment sales are spread for tax-

ation over the period during which the installments are paid. The installment basis of accounting was considered and analyzed by this Court in *Burnet* v. *S. & L. Building Corp.*, 288 U. S. 406. It was there pointed out (p. 413) that prior to the Act of 1926 the Revenue Acts definitely recognized only two bases for tax returns: cash and accrual. Where sales were upon the installment plan, application of either of these bases led to hardship, payment of the total tax on ascertained profit often being required in a single year.[4] By regulations the Commissioner offered some alleviation, and the vendor was allowed to distribute the profit through the years during which purchase money was actually received.[5] The general principle underlying these regulations was to make division of the partial payments and apply part as return of capital and part to profit. In 1926 the Board of Tax Appeals disapproved all of the earlier regulations and pointed out that the statutes permitted returns only upon the cash or accrual basis.[6] Thereupon,

---

[4] On realization of gain, see *McLaughlin* v. *Alliance Insurance Co.*, 286 U. S. 244, 249, *et seq.*

[5] Treasury Regulations 45, Art. 42, *infra*, pp. 40–41. For an exhaustive review of the history of installment sale regulations, see *Blum's, Inc.* v. *Commissioner*, 7 B. T. A. 737, 751, *et seq.*

[6] *B. B. Todd, Inc.* v. *Commissioner*, 1 B. T. A. 762, decided March 16, 1925. See also *H. B. Graves Co.* v. *Commissioner*, 1 B. T. A. 859; *Hoover-Bond Co.* v. *Commissioner*, 1 B. T. A. 929, and *650 West End Avenue Co.* v. *Commissioner*, 2 B. T. A. 958.

Congress enacted Section 212 (d) of the Revenue Act of 1926, *infra,* pp. 37–38. The end in view was to permit the Commissioner to make assessments according to the general principle theretofore followed under regulations deemed appropriate to the varying situations. The new plan was optional. Taxpayers were allowed to elect whether to make returns under the regulations upon the new basis or upon one of the old bases.

Subsequently to the enactment of Section 212 (d) of the Revenue Act of 1926, considered by this Court in *Burnet* v. *S. & L. Building Corp., supra,* it was discovered that the extension of this privilege to taxpayers resulted in the possibility of widespread loss of revenue in the event of a disposition by the vendor of the obligations. Upon such a disposition, as, for example, a transmission of the obligation upon the death of the vendor, the person receiving the obligation would have an entirely new basis upon which to report the payments received from it for income tax purposes. This basis would be the fair market value of the obligation at the time of the transfer. *Brewster* v. *Gage,* 280 U. S. 327. Therefore, any portion of the profit received by the original vendor upon the sale, which under the privilege of installment reporting was not taxed prior to the vendor's death, would remain entirely untaxed.

To remedy this situation, Congress, in reenacting Section 212 (d) as Section 44 (b) of the Revenue

Act of 1928, added a further provision, which is Section 44 (d) of the Revenue Act of 1928, now in issue. Section 44 (d) provided:

> If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

This statute taxes the remaining unreported profit on the sale in the year in which the vendor disposes of the obligations by transmission at death or otherwise. The unreported profit remaining, which is taxed, is computed under the statute as being the fair market value of the obligation at the time of disposal (in the case of transmission at death), less the amount of the original cost basis of the property which has not yet been utilized by the taxpayer in computing profits on earlier installments. The effect of this section, then, is to terminate the privilege of spreading the profit over

a period of years, which is given by the installment method, in any case where the continuation of that privilege would result in the avoidance of taxes on part of the income.

No court that has considered the constitutionality of Section 44 (d) has thought it invalid. On the contrary, the constitutionality of the section has been directly upheld by five Circuit Courts of Appeals, including the court below, and by the Court of Claims. *Lawlor* v. *Commissioner,* 78 F. (2d) 567 (C. C. A. 9th); *Crane* v. *Helvering,* 76 F. (2d) 99 (C. C. A. 2d); *Nuckolls* v. *United States,* 76 F. (2d) 357 (C. C. A. 10th); *Williams* v. *Commissioner,* 79 F. (2d) 518 (C. C. A. 3d); *Provident Trust Co. of Philadelphia* v. *Commissioner,* 76 F. (2d) 810 (C. C. A. 3d); *Moore* v. *United States,* 10 F. Supp. 143 (C. Cls.).

The attack here made on the validity of this section is that it lays a tax on the transmission of installment obligations at death and that such transmission does not result in any income constitutionally taxable under the Sixteenth Amendment. The error in this argument, we submit, is that this section does not and was not intended to tax any purported income arising from the transmission of the obligation at death. The income taxed is the income received by the vendor by reason of the sale transaction. Because of the action of the vendor in choosing to avail himself of the privilege of the installment basis, the vendor was permitted to re-

port this profit piecemeal over a number of years. When, upon the vendor's death, it became no longer possible to tax him in the manner contemplated by the installment basis, the Congress through Section 44 (d) terminated the privilege granted him, and required the remaining portion of the income arising from the sale to be then reported and taxed.

Congress has clearly indicated that, in enacting Section 44 (d), its purpose was to tax the remaining unreported income which had arisen from the prior installment sale. The Ways and Means Committee of the House of Representatives, in reporting the Revenue Act of 1928, said with regard to Section 44 (d) (H. Rep. No. 2, 70th Cong., 1st Sess., pp. 14, 16):[7]

> *Gain or loss upon Disposition of Installment Obligations.*—Subsection (d) contains new provisions of law to prevent evasion of taxes in connection with the transmission of installment obligations upon death, their distribution by way of liquidating or other dividends, or their disposition by way of gift, or in connection with similar transactions. The situations above specified ordinarily do not give rise to gain and yet at the same time it is urged that they permit the recipient to obtain a greatly increased basis in his hands for the property received, except in the case of gifts. It therefore seems desirable to clarify the matter. The installment basis accords the taxpayer *the*

[7] Set out in full, Appendix, *infra*, pp. 46–47.

> *privilege of deferring* the reporting at the time of sale of the gain realized, until such time as the deferred cash payments are made. To prevent the evasion the subsection *terminates the privilege of longer deferring the profit* if the seller at any time transmits, distributes, or disposes of the installment obligations and compels the seller at that time to report the *deferred profits.* [Italics supplied.]

Moreover, that Congress intended by Section 44 (d) to terminate the privilege of reporting the income from the sale on the installment basis and to tax the remaining portion of that income is indicated by the amendment to Section 44 (d) of the 1928 Act, which was incorporated in the section as it appeared in the Revenue Act of 1932.[8] That amendment was as follows:

> SEC. 44. INSTALLMENT BASIS.
>
> (d) *Gain or Loss upon Disposition of Installment Obligations.*—* * * This subsection shall not apply to the transmission at death of installment obligations if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving

[8] That this amendment may properly be considered, see *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312. Cf. *W. A. Sheaffer Pen Co.* v. *Lucas*, 41 F. (2d) 117, 119 (App. D. C.); *United States* v. *Freeman*, 3 How. 556, 564.

> any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment.

This amendment was proposed for reasons explained to Congress by the Senate Committee on Finance, as follows (S. Rep. No. 665, 72d Cong., 1st Sess., p. 21):

> Your committee has added to Section 44 (d) a provision that the subsection shall not apply to the transmission at death of installment obligations if a bond is filed in the proper amount conditioned upon the return as income by any person receiving any payment on account of such obligations of the same proportion of such payment as would have been returnable by the decedent had he lived and received the same. * * *

And in explanation of the action of the House conferees in receding from their objection to the amendment, the conference report stated (H. Rep. No. 1492, 72d Cong., 1st Sess., p. 13):

> Amendment No. 38: The existing law required, in the case of installment obligations transmitted at death, that there be included as income in the return of the decedent for the year of his death the unreturned profit represented by such obligations. This amendment eliminates such requirement if there is filed with the commissioner a bond conditioned upon the return as income, by the person receiving any payment on such

> obligations, of the same proportion of such payment as would be returnable as income by the decedent had he lived and received the same. The House recedes.

It is clear from this legislative history that Congress intended not to tax some new income purporting to have arisen by the transmission of the installment obligation at death, but rather intended to prevent an avoidance of taxes, which otherwise would have resulted from the extension of the privilege of the installment basis.

Petitioner in his brief does not seem to challenge the power of Congress to legislate for this purpose. Petitioner contends, however, that the operation of Section 44 (d) may not always be confined to taxing income theretofore received and unreported, but that it may tax as income what is merely appreciation in value.

1. It would seem to be a sufficient answer to this contention to point out that it does not appear that such a result will follow from the application of the statute in this case. The parties have stipulated (Defendant's Exhibit A, R. 46–48) that if the gain or profit on the $150,000 in installment obligations unpaid at the date of death had been included in the return for 1928, as provided by Section 44 (d), an additional tax would have been disclosed in the sum of $11,625. As an alternative to the installment basis, the petitioner's decedent was taxable, in 1924 alone, upon the cash received plus the fair market value of the purchase money obli-

gations, less cost.[9] Revenue Act of 1924, Sec. 202 (c), 43 Stat. 253. With respect to the $150,000 of unpaid obligations here in question, accordingly, he would have been taxable on the fair market value less $2,500—the unutilized balance of cost. The record is barren of evidence to show that the tax in 1924, so computed, would have been less than the $11,625 here stipulated to be due.

2. Petitioner's argument, however, is built upon a basic misapprehension which ought not to be permitted to go without a direct answer. Application of Section 44 (d) to the fair market value of the unpaid obligations at date of death ($125,000), as seemingly required by its terms, would not have constituted taxation of unrealized income in violation of the Sixteenth Amendment. This is so even though that fair market value—which does not directly appear here—exceeded the fair market value at date of sale.

---

[9] The petitioner in his brief (pp. 13, 14) concedes that this would be the applicable method of taxation if the purchase money obligations had been represented by negotiable promissory notes. See also the illustrative case in Appendix B, p. 48. There is no basis in the Constitution, or in the statutes, or in the practice of the Bureau of Internal Revenue, for the suggestion that this method of treating the fair market value of obligations received as the equivalent of cash must be confined to the case of negotiable notes. Cf. *United States* v. *Phellis*, 257 U. S. 156. The only relevant question is whether the purchase money obligations in fact have a fair market value. The record does not show that the obligation in this case did not have such a value in 1924. That it did is clearly to be inferred from the stipulated fact that the balance of the obligation in 1928 had a fair market value of $125,000 (R. 40).

The fair market value of an installment obligation may increase between the time of sale and the time of death for either or both of two reasons: first, because the obligation does not bear interest and the amount of the discount decreases as maturity approaches; and, second, because the credit of the obligor, being first at a discount, subsequently improves. The first situation is the only one which may conceivably be said to be presented on this record.[10] Both situations, however, are similar in principle; and in neither is the constitutionality of the section, in its ordinary operation, open to question.

The argument for the petitioner confuses problems of accounting method with issues of the realization of income under the Sixteenth Amendment. Accretions in the value of installment obligations subsequent to the date of contract are akin only in exceptional cases to accretions, for example, in the value of land occurring subsequently to its acquisition. The latter are unrelated to the original transaction and independent of it. With respect to them, no taxable event occurs until the land again changes hands. Accretions in the value of installment obligations, on the other hand, grow out of the original agreement, and frequently, as in

[10] The installments in fact had been paid when due. The balance outstanding was recognized in 1928 to be subject only to a discount of 6.348—attributable clearly to the absence of interest (R. 40). There is no evidence whatever that discount for any additional factor would have been appropriate in 1924.

the case of a non-interest-bearing obligation, are precisely responsive to its terms. With respect to profits on the transaction, a taxable event occurs not only at the time of the original agreement but whenever a periodical payment is made. Within broad limits, therefore, the problem is simply one of fair allocation of the cost to be allowed and the gain to be recognized at the time of each payment. The inappropriateness of an attempt to make this allocation conform to a rigid and technical pattern was pointed out by this Court in *Burnet* v. *S. & L. Building Corp., supra.*

Had the petitioner's decedent not elected in 1924 to be taxed upon the installment basis, he would have paid a tax at the capital gain rate upon the sum of the cash payment received and the then market value of the entire unpaid purchase money obligation, less cost. Revenue Act of 1924, Section 202 (c), 43 Stat. 253. That market value would have been determined, in the absence of any question affecting the credit of the maker, by deducting from the face value an appropriate discount from the due dates of the installment payments to the date of sale. The market value, whether or not reflecting any further discount, would have constituted the new basis of the obligation. That portion of each later payment representing an excess over the basis allocable to such payment would have been taxable in later years at the applicable individual normal and surtax rates. Such of those

later taxes as would have fallen due before death must, of course, be taken into account in comparison of the gains taxable upon the installment basis and those taxable upon the normal basis.[11]

The result of such a comparison—so far as the interest factor is concerned—turns upon the method which would have been employed, in taxation on the normal basis, in determining the discounted market value in 1924, and the corresponding method for "recovering" the discount for recognition as income in later years. If each payment were discounted separately from the date of sale to the due date of that payment, and, when the payment was made, only the amount of the discount for that payment recognized as income, then

[11] It is not to be implied from the making of this concrete comparison that taxation under Section 202 (c) of the Revenue Act of 1924 and corresponding provisions of other acts marks the limits of Congressional power. Taxation on the accrual basis, common in the installment business, of course, involves anticipation to much greater degree of actual receipt in cash. The petitioner's decedent elected to be taxed under a remedial statute (Sec. 212 (d) of the Revenue Act of 1926) which fixed as the profit to be taxed the amount "to be realized", that is, the face of the obligation. Fair market value at date of sale has no place, then, in measuring the validity of Section 44 (d). In this situation there was an unreported profit of $147,500 at the time of decedent's death. The amount that could have been taxed under Section 44 (d), under the agreed facts, is $122,500, which eliminates any appreciation to be realized on the face of the unpaid installment obligations involved herein. Congress may constitutionally lay down any measure it sees fit, and certainly any reasonable measure, in a remedial statute which is applicable only upon the election of the taxpayer.

the taxable gains recognized on the normal basis up to and including 1928 would evidently have been less than those recognized on the installment basis through the application of Sections 44 (b) and 44 (d). For, in that case, no gain would have been recognized during the decedent's lifetime upon that portion of the payments falling due after 1928 reflecting the discount upon those payments from the date of sale to 1928. But this differential would merely be a differential incident to a different method of accounting and not, as the petitioner's argument implies, one critical to the power of Congress under the Sixteenth Amendment. Alternatively the discount might have been computed by applying a fixed percentage to the entire unpaid obligation, and "recovering" accordingly as income in later years the same percentage of each installment payment. Under this method, the gain recognized before the decedent's death would probably have been somewhat less (depending upon the percentage used) than that recognized under Sections 44 (b) and 44 (d). But once again, this circumstance is not material to any issue of constitutional power. There remains a third method of determining the proportion of the original discount to be allocated to each payment, which so far as appears would in fact have been followed by the Bureau of Internal Revenue, and under which the total gains recognized would have exactly equalled the gains recognized on the in-

stallment basis through the application of Sections 44 (b) and 44 (d).[12] By this method the taxpayer would have been regarded as recovering as income in 1925, for example, that proportion of the $30,000 payments for that year reflecting the discount upon the entire debt of $270,000 outstanding in that year. Similarly, the payment in 1926 would be regarded as constituting income to the extent of the discount for the entire debt of $240,000 outstanding in the second year. The effect of Section 44 (d)—so far as the interest factor is concerned—is to follow precisely this method. For this method at the end of 1928 would have left the seller untaxed only on the amount of subsequent payments reflecting the discount to 1928 on the debt then outstanding. It is stipulated in this case (R. 40) that the market value of $125,000 in 1928 was determined by discounting to 1928 the payments then outstanding, leaving the seller similarly untaxed to the extent of this discount.

Further discounts in order to determine market value at time of sale, attributable to other factors than the absence of interest, raise no problem importantly different. Like the discount just considered, they will be reflected, when no longer justified, in taxable gains subsequently recognized; and

---

[12] Appendix B, *infra*, p. 48, presents in tabular form a comparison between the gain recognized under Sections 44 (b) and 44 (d) and the gain which would be recognized in taxation on the normal basis under each of the three methods described in the text for computing the discount.

the precise time of their recognition is a question of accounting not touching consfitutional power. As each installment payment falls due, taxation on the normal basis might recognize—for reasons of administrative convenience—only an aliquot portion of any increase in the value of the entire obligation. But surely it would be competent for Congress to tax a greater proportion of the earlier payments by allocating to later payments more than their aliquot share of cost.[13] This is in effect what Section 44 (d) does in recognizing the entire increase. The disadvantage of this recognition, moreover, is counterbalanced by the advantage to the taxpayer in the event of *decrease* in market value between the time of sale and the time of death.

Petitioner's argument assumes a degree of exactitude in the concept of realization of income seldom attributed to it. The assumption will not survive examination. It is evident that different methods of accounting for gains and losses upon installment sales are possible and legitimate; and that the difference in method will affect not only the amount of gain recognized at the inception of the transaction but the precise period of recognition of later gain. In an income tax world of shifting rates and schedules there can be no assurance that the ultimate tax paid upon a given transaction

[13] Special circumstances, of course, might be presented—i. e., an unusually low original discount—in which the amount of any year's payment would set a limit upon the amount of gain to be recognized in that year.

according to one method will precisely equal the tax paid according to another. As in the examples just considered, part of the gain may be taxed at the capital gain rate, while the rest is subjected to the varying individual or corporate normal income and surtax rates. So far as a balance can be struck, from the point of view of the taxpayer, the advantage in ordinary course would appear to be with the installment method. That method—made available as a privilege which might have been withheld—permits postponement of a burdensome weight of taxation which otherwise would be incurred at the outset of an installment transaction. Under Section 44 (d) of the 1928 Act, it has the further advantage—equalled by no other method—of affording the taxpayer protection against *diminution* of the value of the obligation.

Apart from this feature of Section 44 (d), which works in favor of the taxpayer, the installment method under the 1928 Act furnished double assurance to the Government that all profit received on installment transactions would be taxed and to the taxpayer that no greater amount would be taxed.[14] Petitioner's argument seeks to destroy the harmony of this statutory scheme. Its acceptance would result, in circumstances like those of the case at bar, in the escape of substantial profits from any taxation whatsoever. Beyond question, as two Circuit Courts of Appeals have decided—when to

[14] See Appendix B, *infra*, p. 48.

decide more was unnecessary, Section 44 (d) is valid as applied to transactions occurring after its enactment.[15] The reasoning of those decisions will be seen, upon consideration, to be applicable to transactions before as well as after. For petitioner's decedent, in electing the installment basis, did not elect a static method of taxation. Since 1924 the installment method has been expressly validated by Congress, and its details have been altered in various respects to the benefit of the taxpayer. The 1932 amendment removes a final hardship to the taxpayer by permitting the representatives of a decedent to avoid a large lump sum payment in a later year, as the installment method itself permitted the decedent to avoid it in the year of the contract. Taxpayers electing the installment basis have had the advantage of these modifications upon their enactment. They ought not to be permitted to escape the operation of a further modification designed to prevent large amounts of profit, which in the absence of the election might have been taxed, from going untaxed altogether.

CONCLUSION

We conclude that petitioner was constitutionally required by Section 44 (d) of the Revenue Act of 1928 to pay a tax in 1928 on the remaining income from the installment sale, and that the court below correctly held that the District Court erred in re-

[15] *Crane* v. *Helvering*, 76 F. (2d) 99 (C. C. A. 2d); *Nuckolls* v. *United States*, 76 F. (2d) 357 (C. C. A. 10th).

fusing to receive evidence establishing, as a defense to the present suit, the failure of petitioner to report the income and pay the tax thereon.

Respectfully submitted.

STANLEY REED,
Solicitor General.
JAMES W. MORRIS,
Assistant Attorney General.
SEWALL KEY,
GUY PATTEN,
F. A. LESOURD,
Special Assistants to the Attorney General.

OCTOBER 1937.

APPENDIX A

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 202.

* * * * *

(c) The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * *

SEC. 212.

* * * * *

(d) Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision, the term "initial payments" means the payments received in cash or property other than evi-

dences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

SEC. 1208. The provisions of subdivisions (d) of section 212 shall be retroactively applied in computing income under the provisions of the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, the Revenue Act of 1921, or the Revenue Act of 1924, or any of such Acts as amended. Any tax that has been paid under such Acts prior to the enactment of this Act, if in excess of the tax imposed by such Acts as retroactively modified by this section, shall, subject to the statutory period of limitations properly applicable thereto, be credited or refunded to the taxpayer as provided in section 284.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in personal property.*—Under regulations proscribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of realty and casual sales of personalty.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real

property, if in either case the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(d) *Gain or loss upon disposition of installment obligations.*—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 44. INSTALLMENT BASIS.

* * * * *

(d) *Gain or Loss upon Disposition of Installment Obligations.*—* * * This subsection shall not apply to the transmission at death of installment obligations if there is

filed with the Commissioner, at such time as he may by regulations prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment.

Treasury Regulations 45:

ART. 42. *Sale of personal property on installment plan.*—Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25 per cent) that the sale, though involving deferred payments, is not one on the installment plan. In sales on personal credit, and in the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash, but a different rule applies to sales on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (*a*) Through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (*b*) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (*c*) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by conveyance to

a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from installment sales (such collections being allocated to the year against the sales of which they apply), which the annual gross profit to be realized on the total installment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale or contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the installment plan of computing net income, no part of any installment payment received subsequent to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the installment payment is received; the intent and purpose of this provision is that where the entire profit from installment sales has been included in gross income for the year in which the sale was made, no part of the installment payments received subsequently on account

of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance sheet should be adjusted conformably. If for any reason the vendee defaults in any of his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profits already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible.

Treasury Regulations 74:

ART. 355. *Gain or loss upon disposition of installment obligations.*—If an installment obligation is satisfied at other than its face value or is sold or exchanged, gain or loss results to the extent of the difference between (1) the excess of the face value of the obligation over the amount of income which would be returnable were the obligation satisfied in full and (2) the amount realized upon such disposition.

If an installment obligation is distributed, transmitted, or disposed of otherwise than by sale or exchange, gain or loss results to the extent of the difference between (1) the excess of the face value of the obligation over the amount of income which would be returnable were the obligation satisfied in full and (2) the fair market value of the obligation at the time of such distribution, transmission, or disposition.

The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations shall be recognized except as provided in section 112 and articles 571–580.

Example (1): In 1928 the M Corporation sold a piece of real estate to B for $20,000. The company acquired the property subsequent to February 28, 1913, at a cost of $10,000. During 1928 the company received $5,000 cash and the vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. Before the vendee made any further payments the company sold the notes for $13,000 in cash. The company derived taxable income in the amount of $5,500 from the sale of the notes, computed as follows:

Proceeds of sales of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit to be realized when property is paid for	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Excess of face value of note over amount of income returnable were the notes satisfied in full		7,500
Taxable income derived from sale of notes		5,500

Example (2): Suppose in the example given above the M Corporation, instead of selling the notes, distributed them to its shareholders as a dividend, and at the time of such distribution the fair market value of the notes was $14,000. The company would derive taxable income in the amount of $6,500 from such disposition of the notes, computed as follows:

Fair market value of notes	$14,000
Excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (*l*))	7,500
Taxable income derived from disposition of notes	6,500

S. Rep. No. 52, 69th Cong., 1st Sess., p. 19:

Section 212 (d): The revenue act of 1924 and prior acts have specifically provided two bases only for reporting income—first, cash receipts and disbursements, and, second, accrual. Since the enactment of the revenue act of 1921, however, section 202 (f) and its successors have impliedly recognized the existence of a third basis, the installment basis, without in any wise defining the situations and businesses to which such basis might be applied. The Commissioner of Internal Revenue has in his regulations provided, in pursuance of his authority to require a method of computation that will clearly reflect income, the installment basis for reporting income in certain cases. For instance, Regulations 65, as issued under the revenue act of 1924, provides that all dealers in personal property sold on the installment plan, whether or not title remains in the vendor until payment is completed, may return as income that proportion of the total cash collections received in the taxable year from installment sales which the annual gross profits on the total sales made during each year bear to the gross contract prices of all such sales. Vendors in isolated sales of personal property or in sales of real property on deferred-payment plans may return as income as of the year of actual receipt that proportion of each payment which the profit upon completion of all payments bears to the contract price, subject to the limitation, however, that the initial pay-

ment must not exceed 25 per centum of the contract price.

However, recent decisions of the Board of Tax Appeals (see appeal of 650 West End Ave. Co., appeal of Manomet Cranberry Co., and appeal of B. B. Todd (Inc.)—all decided during the past year) have held that similar regulations under earlier acts were invalid and that the commissioner under the law could authorize no basis other than the cash receipts and disbursements basis or the accrual basis, except for certain minor departures. The committee amendment, in order to meet the situation resulting from the decisions, places the principles of the commissioner's regulations in the law and thereby validates the regulations for all periods after January 1, 1925.

Deferred-payment contracts other than installment contracts are not affected by the committee amendment. When the initial payment exceeds 25 per cent of the price in the case of an isolated sale of personal property, or in the case of sales of real property, the obligations that are received in addition to the initial payment are to be regarded as the equivalent of cash if such obligations have a fair market value. In consequence that portion of the initial payment and of the fair market value of such obligations which represents profit is to be returned as income as of the taxable year of the sale.

The application of the installment basis as provided in the committee amendment should eliminate necessity for appraisals of the obligations of the purchaser in deferred-payment sales, as required under the Board of Tax Appeals decisions, save in those cases where, because of a large initial payment, i. e., one in excess of 25 per cent of the price,

the property sold and serving as security for the unpaid balance has a value adequate to give the obligations a market value.

H. Rep., No. 2, 70th Cong., 1st Sess., p. 16:

Gain or Loss upon Disposition of Installment Obligations.—Subsection (d) contains new provisions of law to prevent evasion of taxes in connection with the transmission of installment obligations upon death, their distribution by way of liquidating or other dividends, or their disposition by way of gift, or in connection with similar transactions. The situations above specified ordinarily do not give rise to gain, and yet at the same time it is urged that they permit the recipient to obtain a greatly increased basis in his hands for the property received, except in the case of gifts. It therefore seems desirable to clarify the matter. The installment basis accords the taxpayer the privilege of deferring the reporting at the time of sale of the gain realized until such time as the deferred cash payments are made. To prevent the evasion the subsection terminates the privilege of longer deferring the profit if the seller at any time transmits, distributes, or disposes of the installment obligations and compels the seller at that time to report the deferred profits. The subsection also modifies the general rule provided in subsection (a) for the ascertainment of the percentage of profit in the deferred payments, in those cases in which the obligations are satisfied at other than their face value or are sold or exchanged. The modification permits a compensating reduction in the percentage of profit in case the obligations are satisfied

at less than their face value, or are sold or exchanged at less than face value.

* * * * * *

S. Rep. No. 665, 72d Cong., 1st Sess., p. 21:

SECTION 44 (d). TRANSMISSION AT DEATH OF INSTALLMENT OBLIGATIONS.

Your committee has added to section 44 (d) a provision that the subsection shall not apply to the transmission at death of installment obligations if a bond is filed in the proper amount conditioned upon the return as income by any person receiving any payment on account of such obligations of the same proportion of such payment as would have been returnable by the decedent had he lived and received the same. It has come to the attention of your committee that considerable hardship sometimes occurs in the application of existing law to cases of decedents who die possessed of substantial amounts of installment obligations. In such cases the entire amount of the profit represented by the obligations must be reported as income in the return of the decedent for the year of his death. Your committee believes that if, for example, the estate of the decedent or his next of kin or legatees file a bond to return as income the proper proportion of the payments received by them on account of the installment obligations received from the decedent, the revenue will be properly protected. This section is accordingly amended to provide for such procedure.

APPENDIX B

Taxation of gains upon sale of stock costing $5,000 for $300,000—$30,000 down payment and nine annual installment payments of $30,000 each

Year taxable	Description of payment		Installment basis, R. A. 1928, § 44	Normal basis, R. A. 1924, § 202 (c), flat rate of discount	Normal basis, R. A. 1924, § 202 (c), discounting each payment separately	Normal basis, R. A. 1924, § 202 (c), discounting whole outstanding debt for each year
1924	Sales price, cash	$30,000.00				
	Market value of obligation	200,994.65				
	Total	230,994.65				
	Less: Cost	5,000.00				
				$225,994.65	$225,994.65	$225,994.65
1924	Down payment	30,000.00	$29,500.00			
1925	Installment payment	30,000.00	29,500.00	7,667.26	1,790.87	12,757.29
1926	Installment payment	30,000.00	29,500.00	7,667.26	3,474.69	11,664.85
1927	Installment payment	30,000.00	29,500.00	7,667.26	5,058.01	10,500.93
1928	Installment payment	30,000.00	29,500.00	7,667.26	6,546.82	9,263.13
	Commuted value of remaining obligations, assuming that death of taxpayer occurred December 31, 1928	125,182.85				
	Less: Unrecovered cost	2,500.00				
			122,682.55			
	Profit taxable to taxpayer		270,182.85	254,663.69	242,865.04	270,182.85

	Profit Taxable to Taxpayer's Estate				
1929	Discount fifth installment	7,946.76	4,963.43	1,790.87	7,946.76
1930	Discount sixth installment	6,546.82	4,963.43	3,474.69	6,546.82
1931	Discount seventh installment	5,058.01	4,963.43	5,058.01	5,058.01
1932	Discount eighth installment	3,474.69	4,963.43	6,546.82	3,474.69
1933	Discount ninth installment	1,790.87	4,963.43	7,946.76	1,790.87
	Profit taxable to estate	24,817.15	24,817.15	24,817.15	24,817.15
	Total	295,000.00	279,480.84	267,682.19	295,000.00

U. S. GOVERNMENT PRINTING OFFICE: 1937